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March 17, 2008

**AGENDA ITEM 10a**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Assembly Bill 1967 (Torrico)—As Introduced  
February 14, 2008  
*Sponsor: Service Employees International Union*
- II. PROGRAM:** Legislation
- III. RECOMMENDATION:** Oppose
- IV. ANALYSIS:**

**Executive Summary**

AB 1967 would severely restrict CalPERS' ability to invest in top-quartile private equity funds. The bill would prohibit CalPERS from making a direct investment in a private equity company owned to any degree by certain sovereign wealth funds (SWFs). In addition, CalPERS would be prohibited from making an investment in any private equity fund managed directly or indirectly by a private equity company owned to any degree by certain SWFs. CalPERS Investment Staff and the Board's AIM consultant, Pension Consulting Alliance (PCA), strongly recommend an *oppose* position (Attachment) since AB 1967 would severely limit the CalPERS Alternative Investment Management ("AIM") Program's ability to obtain first-quartile returns in the private equity asset class.

**Background**

**Article XVI, Section 17 of the California Constitution**

Article XVI, section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The California Constitution, however, provides that the Legislature may, by statute, continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the required standards of fiduciary care and loyalty.

### AIM Program

Private equity investments are managed through the CalPERS AIM Program. Since inception in 1990 to September 30, 2007, the AIM Program has generated \$12.6 billion in profits for CalPERS. Over the last 10 years (through September 30, 2007), the AIM Program generated an annual return of 14.1% compared to an annual return of 6.6% for the Wilshire 2500 ex-tobacco index. The AIM Program's goal is to perform as "an investor of choice" by partnering with the world's leading private equity firms in order to achieve superior risk-adjusted returns.

The AIM Program currently has relationships with over 100 private equity firms. Some of these firms have sold minority equity stakes to outside investors, including SWFs. On a few occasions, CalPERS has itself invested in private equity companies. In all instances of which CalPERS is aware, outside investors only have minority, non-controlling, passive ownership stakes. To date, the firms that have been able to attract outside capital are among the most successful private equity firms in the industry.

### Proposed Changes

AB 1967 would enact the Responsible Private Equity Investment Act of 2008 that would apply to CalPERS and CalSTRS.

- ❖ AB 1967 would prohibit CalPERS from investing in a private equity company that is owned in whole or in part by a SWF as defined,<sup>1</sup> or in a private equity fund managed directly or indirectly by a private equity company that is owned in whole or in part by a SWF, if any country or federation of countries with which the SWF is affiliated, either directly or indirectly, is not a signatory or party to at least five of six listed international treaties covering basic human rights.
- ❖ AB 1967's prohibition would be suspended if the United States Department of State has determined in the most recent human rights report that those country, countries, or federation of countries ("country") with which the SWF is affiliated, generally respects the human rights of its citizens, or if the country is not reviewed in that report.
- ❖ If the prohibition to invest does not apply pursuant to the rules summarized above, AB 1967 would nonetheless require CalPERS to evaluate the country affiliated with an SWF before making any additional or new investment, or renewing any existing investment in a private equity company in which an SWF affiliated with that country is an investor, or in any private equity fund managed by such a company and to issue a detailed written evaluation report. The report would have to be made available to the public and on the Internet at least 60 days prior to any final investment decision. If the evaluation concludes that the

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<sup>1</sup> AB 1967 defines "Sovereign Wealth Fund" as a "government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the relevant country's monetary authority."

country with which the SWF is affiliated has a serious lack of transparency, lack of respect for internationally recognized human rights, lack of productive labor practices, or lack of compliance with the applicable principles for socially responsible investing, the bill would prohibit investing in these companies and funds.

- ❖ AB 1967 would require CalPERS, on or before January 1, 2010, and every year thereafter, to file reports with the Legislature on private equity investment decisions relating to SWFs.
- ❖ AB 1967 contains the same fiduciary duty safe harbor as found in the Sudan and Iran divestment statutes; so that the CalPERS Board may decide that the law's required action is inconsistent with its fiduciary responsibilities under the California Constitution.
- ❖ AB 1967 provides for indemnity by the State of California for the present, former, and future board members, officers, and employees of, and investment managers under contract with CalPERS in connection with any evaluation, report, or investment decision made in compliance with its provisions.

### **Legislative History**

- 2007 Chapter 671 (AB 221, Anderson) – This bill would prohibit CalPERS and CalSTRS from investing in a company that is invested or is engaged in business operations with entities in the defense or nuclear sectors of Iran, or in the development of petroleum or natural gas resources of Iran; and that company is subject to sanctions under Public Law 104-172. Also, the bill would require the boards of these retirement systems to sell or transfer any investments in these companies and report to the Legislature regarding these investments, as well as on costs and losses incurred as a result of the divestment. *CalPERS Position: Oppose*
- 2006 Chapter 442 (AB 2941, Korte) – Prohibits CalPERS and CalSTRS from investing public employee retirement funds in a company with active business operations in Sudan, and would require the boards of these retirement systems to sell or transfer any investments in these companies within specified timeframes. The boards of these retirement systems would be required to submit a specified annual report to the Legislature on or before January 1, 2008. Although CalPERS typically opposes any divestment legislation, the Board determined this situation was unique enough to approve a neutral with suggested amendments position. The amendments would indemnify the fund (not accepted by author) and ensure the bill does not impact the Supplemental Savings Program (accepted by the author). The Board also directed staff to seek a separate indemnification bill for the fund. Staff did not find an author. *CalPERS Position: Neutral, with suggested amendments.*

- 2001 SJR 9 (Costa) – Would have urged the Federal government to assume its proper leadership role in assisting investors in avoiding investing in entities that are deemed threats to the national security of the United States. Failed passage. *CalPERS Position: Sponsor*
- 2000 AB 107 (Knox) – Would have prohibited CalPERS and CalSTRS from making any new or additional investments in tobacco companies beginning January 1, 2001 and requires divestment of existing investments by July 1, 2002. Failed Passage. *CalPERS Position: Oppose*
- SB 1928 (Haynes) – Requires CalPERS and CalSTRS to report on the extent to which they are invested in foreign companies that pose threats to national security, and encourages the boards of these pension funds not to invest in those companies. Held in Assembly.  
*CalPERS Position: Oppose*
- AB 2745 (Kaloogian) – would enact the California State Investment Transparency and Disclosure Act which would encourage CalPERS and CalSTRS not to invest in foreign companies that pose threats to national security. This bill would require CalPERS and CalSTRS to investigate and report to the Legislature each year the extent to which international companies CalPERS and CalSTRS were invested in the prior 12 months are doing business in countries which are terrorist sponsoring nations. The bill was held in the Assembly Appropriations Committee suspense file. *CalPERS Position: Oppose*
- 1998 AB 1679 (Perata) – Would have prohibited state trust fund and state money investments in tobacco companies. Failed Passage.  
*CalPERS Position: Oppose*
- AB 1744 (Knox) – Would have prohibited CalPERS and CalSTRS from making new or additional investments in any tobacco company on or after January 1, 1999. This bill would also require a phased divestment of those investments beginning January 1, 2000 and continuing until January 1, 2002. Failed Passage. *CalPERS Position: Oppose*
- SB 1433 (Hayden) – Would have required CalPERS and STRS to not make new or additional investments in tobacco companies. Failed Passage. *CalPERS Position: Oppose*
- 1994 Chapter 30 (SB 1285, Watson) – Repealed provisions prohibiting investments in South Africa. *CalPERS Position: Support*
- 1992 Chapter 1351 (AB 2251, Margolin) – Prohibited state trust fund and state money investments in business firms or financial institutions that engage in discriminatory business practices after January 1, 1994 relating to the Arab League's economic boycott of Israel. *CalPERS' Position: Oppose*

- 1989 AB 2530 (Bentley) – Prohibited the investment in companies doing business with the People’s Republic of China. Failed passage.  
*CalPERS’ Position: Oppose*
- 1986 Chapter 1254 (AB 134, Waters) – Prohibited the use of state trust funds or state moneys to make additional or new investments, or to renew existing investments in firms doing business with or in South Africa as of January 1, 1987. *CalPERS Position: Neutral*
- 1987 AB 1935 (Hayden) – Requires that Northern Ireland investment be only made through companies that have made advances in the elimination of ethnic or religious discrimination. Failed passage.  
*CalPERS’ Position: Oppose*
- 1983 (AB 808, Watson)—Would have prohibited the use of state funds for investment in the stock of financial institutions having outstanding loans to the government of South Africa after January 31, 1985. Would have required complete divestment of state funds in any American company doing business in South Africa by January 1, 1989. Provided an exception for any financial institution adopting a policy including a commitment not to renew existing loans or to make new loans to the South African public sector. Vetoed by Governor Deukmejian.  
*CalPERS’ Position: Oppose*

## **Issues**

### **1) Arguments in Support**

The sponsor states, “Absent overriding fiduciary obligations, AB 1967 would prevent California’s retirement systems from undermining human rights by making new investments or renewing investments with private equity firms partly owned by sovereign wealth funds that have not signed on to basic human rights treaties and do not generally respect the rights of their citizens.”

*Organizations in Support: SEIU (Sponsor)*

### **2) Arguments in Opposition**

According to CalSTRS, AB 1967 arbitrarily restricts its investment opportunities; infringes on the federal government’s constitutional role to create foreign policy and federal legislation governing direct foreign investment; and would increase its unfunded actuarial obligation by several billion dollars in the next five years.

*Organizations in Opposition: California State Teachers’ Retirement System*

3) AB 1967 Will Severely Impact The Returns Of The AIM Program

If CalPERS is prohibited from investing in private equity firms partially owned by an SWF, the investment performance of the AIM program will be materially adversely affected. CalPERS currently has relationships with private equity firms that have SWFs as minority owners. Collectively these firms manage in excess of \$9 billion on behalf of AIM, or approximately 20% of the assets in the AIM Program. If CalPERS had not invested in funds sponsored by the private equity companies targeted by AB 1967, its investment gains would have been \$3 billion less.

CalPERS Staff believes that many other top-quartile private equity companies may sell minority equity stakes to SWFs in the near to interim term. This would further restrict the universe of funds in which the AIM Program could invest. In an investment environment where there is competition among limited partners for the opportunity to invest in the best performing funds, this likely would have a material impact on the performance of the AIM Program

The passage of AB 1967 will also impact CalPERS' investments with those top-quartile funds that have no SWF ownership. The private equity community has previously expressed concerns that having CalPERS as a limited partner will subject funds to political interference. AB 1967 would prove these fears to be justified. Therefore, it would materially impact CalPERS' ability to maintain its "investor of choice" status with all top-quartile funds, making it more difficult to obtain allocations in all top-quartile funds and negotiate acceptable terms and conditions.

Obtaining allocations in top-quartile funds is crucial to the success of the AIM Program. CalPERS investment staff's research, as well as research conducted by McKinsey & Company and PCA, indicates that top-quartile funds continue to out perform over time. Private equity investments are not fungible.

CalPERS Staff believes that if AB 1967 is passed it is much more likely that CalPERS will not be able to obtain first quartile returns in the future because it would cut off CalPERS' access to top-quartile funds. This may even be the case if CalPERS Board concludes that it cannot follow AB 1967's restrictions because doing so would violate CalPERS Board's fiduciary duty. If CalPERS loses access to top-quartile private equity funds, the expected returns of the AIM Program would not justify continuing to invest in the asset class, because the lower expected returns would not compensate CalPERS for the greater level of risk associated with private equity. Over time, this would result in CalPERS having significantly less allocation to private equity, which would reduce overall diversification of CalPERS' assets and reduce returns.

While it is not possible to predict future returns, the potential impact to CalPERS from not investing in private equity funds could be quite substantial. Our experience and expectations have been that the best private equity firms with

which we invest have earned premium returns over those available in the public markets. Given our target outperformance of 5 percent and with a 10 percent portion of the PERF allocated to private equity, the expected annual cost for compromising this program could represent  $.05 * .1 * \$240$  billion, or \$1.2 billion annually, or \$12 billion over the coming decade. Furthermore, the opportunity costs associated with these foregone investments would be expected to grow proportionately with growth in the PERF.

4) Drafting Issues Compound the Potential Impact of AB 1967 on CalPERS' Investment Returns

The bill's adverse impact would be compounded by its lack of clarity. For example, as currently drafted, it would potentially prohibit CalPERS' from investing as a limited partners in any private equity fund in which a SWF also owns a passive limited partnership interest. As a limited partner, CalPERS has no influence over what other investors the general partner allows to invest in the fund. The sponsor of the bill has indicated that this was not the intent, but no amendment has been proposed to fix this error. As written, the bill therefore could potentially impact over 60% of the investments in the AIM Program.

In addition, the bill could apply to (1) real estate funds and (2) corporate governance funds or hedge funds that have private equity investments. Again, the sponsor of the bill has indicated that this was not the intent, but no corrective amendment has been proposed to date. Finally, the bill might prohibit CalPERS from satisfying capital calls made pursuant to existing commitments. If so, CalPERS could be penalized for breaching contracts and face costly lawsuits. In addition, this could have a negative impact on the entire private equity market by creating financial uncertainty.

5) The Foreign Policy Issues Related to SWFs are Best Left to the Federal Government

Legitimate concerns relating to SWFs such as transparency, human rights, and national security, etc., are best left to the federal government to address.<sup>2</sup>

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<sup>2</sup> The Treasury Department, along with finance ministries from the rest of G8, has asked the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) to begin working on best practices relating to SWFs. The IMF recommendations, due this fall, are expected to focus on enhancing SWF transparency in order to increase the number of SWFs that publish annual accounts and provide outsiders some insight into governance and investment strategies. The OECD has begun working on best practices for host countries, and in particular the processes of host country review of SWF investments.

The U.S. Congress has created a bipartisan task force to investigate SWFs potential effect on geopolitics, and the U.S. and international economy. Possible policy proposals the task force may consider include the adoption of new transparency rules. Similarly, the European

CalPERS does not have the expertise to analyze and address these concerns. The federal government, not state governments, oversees international trade and foreign policy issues and has the power to negotiate and enforce international agreements on trade and investment.

6) Indemnification Provision Does Not Indemnify the Fund

AB 1967 includes an indemnification provision identical to the one contained in AB 221 that enacted the Iran divestment requirement in 2007 and AB 2941 that enacted the Sudan divestment requirement in 2006. Specifically, AB 1967 would provide that the State General Fund would indemnify present and former CalPERS Board members, state officers and employees, and investment managers from all liability, losses or damages sustained by reason of any decision not to invest in private equity companies or funds in compliance with the AB 1967. The indemnity provision, however, would not cover losses to the retirement fund, itself.

7) Legislative Policy Standards

The Board's Legislative Policy Standards provide for an *oppose* position on proposals that would impose any investment mandate or restriction on the Board's investment authority, or proposals that would impose unreasonable cost or complexity for the administration of the system. AB 1967 would do both.

**V. STRATEGIC PLAN:**

This is not a specific product of the Annual or Strategic Plans, but is part of the regular and ongoing workload of the Office of Governmental Affairs.

**VI. RESULTS/COSTS:**

AB 1967 would restrict the investment opportunities available to CalPERS and decrease the diversification of the System's assets. Reducing diversification results in higher expected volatility of investment results or a lower expected return, which could lead to higher employer contributions.

**Program Costs**

While it is not possible to predict future returns, the potential impact to CalPERS from not investing in private equity funds could be quite substantial. Our experience and expectations have been that the best private equity firms with which we invest have earned premium returns over those available in the public markets. Given our target outperformance of 5 percent and with a 10 percent portion of the PERF allocated to private equity, the expected annual cost for compromising this program

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Union has called on SWFs to sign up to a voluntary code of conduct that includes "a set of principles for transparency, predictability and accountability."



could represent  $.05 * .1 * \$240$  billion, or \$1.2 billion annually, or \$12 billion over the coming decade. Furthermore, the opportunity costs associated with these foregone investments would be expected to grow proportionately with growth in the PERF. Any opportunity costs incurred as a result of this bill would have to be made up by the state, school districts and contracting agencies through higher contribution rates.

### **Administrative Costs**

AB 1967 would require extensive fact-based research on any potential new investment in private equity funds, hedge funds, corporate governance funds or real estate to determine if the investment falls under the provisions of the bill. The bill requires country-related research that is similar to the research conducted pursuant to the country research performed under the Board's prior Permissible Country Policy, which was quite costly.

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